Manuel Sánchez: The United States and Mexico – a lasting bond

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the Mosbacher Institute, Bush School of Government and Public Service, Texas A&M University, College Station, Texas, 15 September 2016.

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It is a pleasure and an honor to participate in the series "Conversations in Public Policy" held by the Mosbacher Institute at the Bush School at Texas A&M University. The occasion is important for at least two reasons. Texas A&M is a world-renowned educational and research center, with a 140-year history, and it is located in the state with the most significant social and economic connections to Mexico. The longstanding relationship between the Lone Star State and Mexico is deeply rooted in a common cultural and social heritage.

Today, I would like to talk first about the long-term economic ties between the United States, in particular Texas, and Mexico. Second, I will focus on financial markets and challenges. Third, I will examine recent economic developments and the outlook, and finally, discuss inflation and monetary policy in Mexico.

As usual, my remarks are entirely my own and do not necessarily reflect those of the Bank of Mexico or its Governing Board.

Long-term economic ties

Mexico has long been in a process of increasing economic integration with the United States, encompassing goods and services, capital, and labor markets. These links, reinforced by the North American Free Trade Agreement, have yielded substantial benefits on both sides of the border, including more competition, efficiency, job creation, and consumer wellbeing. The most significant bond with any state is with Texas, given its place as the tenth largest economy in the world and the extensive border it shares with Mexico.

In terms of trade of goods, the United States is Mexico's most important partner in both imports and exports, while Mexico is second in exports and in imports for the United States. Texas, however, is number one in both categories for Mexico – and vice versa.

The backdrop to bilateral merchandise trade is a long-term, growing industrial integration between the two countries. In particular, Mexico's manufacturing production holds an extraordinarily high correlation with U.S. manufacturing output.

Also, the United States, and Texas in particular, are important providers of foreign direct investment to Mexico, transferring technology and knowhow, while exploiting mutually advantageous business opportunities. In fact, Mexico is the second most important destination for Texan foreign direct investment, following only Canada.[1]

Finally, Mexico's net labor migration to the United States and Texas has been significant over the years. However, Mexican net labor flows to the United States have diminished notably since 2008 and have been negative in some years. Several factors may be behind this phenomenon, including falling fertility rates and cyclical factors, such as low growth in U.S. economic sectors which typically have been Mexican labor absorbers – for example, construction – as well as rising employment in Mexico.[2]

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1 See Texas Wide Open for Business (2016). *Texas Foreign Direct Investment 2016*.

2 See Pew Research Center (2015). *More Mexicans Leaving Than Coming to the U.S.*, Washington, D.C.: November; and Orrenius, P. M. (2016). "The End of Mass Migration from Mexico," presented at The Political Economy of Texas-Mexico: Common Bonds, Shared Challenges, April.

Worker remittances from the United States dropped amid the global financial crisis, and since 2010 have exhibited a discontinuous recovery, reaching nominal pre-crisis levels only recently. These money transfers contribute substantially to the standard of living of many families in Mexico, helping them to meet basic needs, such as longer schooling and better housing.[3]

Going forward, it is only natural that social and economic integration between the two countries augment. An increasing array of opportunities will continue from the current reform agenda undertaken by Mexico. Telecom and energy reforms are already making themselves felt. The latter is especially important for an energy power house such as Texas.[4]

Financial markets and challenges

Since the middle of 2014, risk aversion has increased, hitting emerging markets especially hard. A reflection of this has been a decline in the prices of many commodities and emerging-market financial assets, including some upward pressure on interest rates, but more persistently, widespread downward pressure on currency levels against the U.S. dollar.

Behind this shift are various factors, beginning with worries over the state of the Chinese economy and policy moves there to handle any deterioration. Also, geopolitical developments such as Brexit may have had a part. However, the most important by far has been uncertainty over imminent U.S. monetary policy normalization.

Market expectations and the beginning of normalization have had significant implications for financial flows to emerging economies. Around the world, U.S. monetary accommodation fueled the search for yield through significant portfolio capital inflows to emerging markets. Since 2014, however, these flows have slowed, turning negative in some recent quarters.[5]

Furthermore, data-driven U.S. monetary policy has generated financial volatility. Portfolio capital flows are highly sensitive to revised expectations of changes in U.S. policy rates. Additionally, asset prices react rapidly to any economic news. If the perception is of a stronger-than-expected economy, they tend to fall in anticipation of tighter policy, and vice versa.[6]

Mexican financial markets have adjusted to this environment mainly through the exchange rate. Long-term interest rates, low by historical standards, have remained relatively stable since an upward adjustment in 2013 in the wake of the infamous taper tantrum.

Along with other emerging-market currencies, the Mexican peso has depreciated significantly since 2014. However, during the present year, the weakening of the currency has been more substantial than in other emerging economies. In addition to fears surrounding U.S. hikes, other aspects more specific to Mexico seem to be at play.

A first contributing factor is Mexico's weak fiscal position. Over the last several years, the historical balance of public-sector borrowing requirements relative to GDP has been persistently rising, to reach around 50 percent in 2016. Also, financial deterioration in state-owned oil company Pemex, due in large part to lower international oil prices, has been a

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[3] See Alcaraz, C., et al. (2012). "Remittances, Schooling, and Child Labor in Mexico," *Journal of Development Economics*, 97(1).

[4] For an exposition on the energy reform in Mexico, see Torres-Barron, B. (2016). "Mexico's Energy Sector: Trends and opportunities," presented at The Political Economy of Texas-Mexico: Common Bonds, Shared Challenges, April.

[5] See Koepke, R. and S. Farnham (2016). "August 2016 EM Portfolio Flows Tracker," *The IIF Portfolio Flows Tracker*, September.

[6] See Koepke, R. (2016). "Fed Policy Expectations and Portfolio Flows to Emerging Markets," *IIF Working Paper*, September.

concern. The fiscal gap has been mirrored in a widening current account deficit, mainly reflecting the oil trade account.

Mexico's fiscal finances may be on an unsustainable path, and the public debt ratio appears to have reached a limit, at levels that may not be healthy. Relative government indebtedness is already higher than in many other emerging markets. Also, Mexico's sovereign credit risk perception, as measured by CDS premiums, has remained above that of other countries with the same rating. Furthermore, rating agencies have given Mexico a clear warning this year in the form of a downward change in perspective.

A second contributing factor to peso depreciation may be markets' disappointment on lower-than-expected growth in Mexico. A third cause may stem from uncertainty on the forthcoming U.S. presidential election and its implications. Finally, given the depth and liquidity of the peso market, and the fact that derivatives are used to hedge peso positions and as a proxy for other emerging-market asset investments, price swings for the Mexican currency may be exacerbated.

Volatility could easily increase in the future, in light of so many unknown global geopolitical and financial variables. This situation could be even more risky in the face of Mexico's high exposure to foreign holdings of peso-denominated government debt. These holdings represent one of the highest proportions of the total outstanding of local currency debt in the emerging-market group, decreasing somewhat during the last two years, at close to a third, with the drop concentrated mainly in short-term securities. The still high ratios of foreign holdings could be interpreted as a positive sign. The tables could rapidly turn, however, if perception of strength evaporates.

Therefore, it is absolutely urgent that Mexico strengthen its fiscal stance in an unambiguous way, cutting public expenditures significantly in order to stabilize, and eventually reduce, total government debt to GDP. Obviously, monetary policy should also continue to carry its weight in the effort to fortify macroeconomic fundamentals.

Recent economic developments and outlook

Since 2014, GDP has risen at a relatively stable rate of around 2.3 percent year-on-year, including a dip in the 2016 second quarter. Two offsetting forces have contributed: expansion in services and decelerating industrial production. Recently, the pace has slowed in both sectors.

The main drag on industrial output has been a contraction in mining, driven by a longstanding decline in oil extraction. Manufacturing production has also been slowing to almost no growth recently. To a large extent, these developments have resulted from a falling trend in U.S. manufacturing production and a contraction in manufacturing exports to the United States since 2015, despite the significant real depreciation of the Mexican peso against the dollar.[7]

Less Mexican manufacturing dynamism seems to have begun to affect important segments of the services sector, such as commerce and transportation, highly correlated with manufacturing, a worrisome event given that the services sector has been a key growth engine in the past few years. On the demand side, Mexico's economic slowdown is evident in lower increases in private consumption, and especially a decelerating trend in total investment.

[7] Statistical data point towards a stable relationship between Mexican non-auto manufacturing exports to the United States with U.S. manufacturing production, U.S. exports to the world, and the bilateral real exchange rate. Banco de México (2016). *Informe Trimestral Abril-Junio 2016*, August, Box 2, pp. 30–33.

Analysts' consensus forecasts are for a transitory loss of vigor in the Mexican economy this year, followed by a growth figure slightly below the historical average in 2017. The economic scenario, however, faces risks, among which those to the downside seem to prevail.[8]

In the short term, possible negative effects include a deeper deceleration for the global economy and U.S. manufacturing production, additional reductions in Mexican oil extraction, and softer business confidence and private investment. In the medium term, dangers encompass obstacles to adequate implementation of structural reforms, where education stands out, as well as growing international protectionism.

Inflation and monetary policy

Since 2015, inflation in Mexico has exhibited benign behavior. In annual terms, it has converged to the 3 percent target established by the Bank of Mexico more than 10 years ago. Furthermore, and in stark contrast with previous trends, inflation has been continuously below the target.

Subdued headline inflation has been supported by unusually reduced rises in the noncore component of the CPI. Specifically, since the middle of last year, noncore inflation has averaged only 2.3 percent, contrasting with the roughly 6 percent average during this century.

On the other hand, core inflation has been growing gradually this year, largely reflecting moderate pass-through from currency depreciation to tradable goods prices. So far, this effect has been relatively mild, and core inflation has not breached 3 percent. In addition, exchange rate pass-through to merchandise prices has been somewhat compensated for by lower telecom prices, reflecting more competition in the sector.

Two warning signals that would argue against continued consumer price stability are a rising trend in producer price changes, which could be partly translated to final goods, and an interruption in convergence of medium-term inflation expectations to the target, as measured by analysts' surveys.[9]

Upside risks to inflation appear to dominate. The largest concern relates to the possibility of higher contagion from Mexican peso weakening, which could generate deviation of inflation and expectations from the target. Sudden increases in pass-through cannot be ruled out.

Two other risks are the reversion of noncore inflation to its historical mean, with possible second-round effects. The potential emergence of aggregate demand pressures are also important, given uncertainty regarding the true level of potential GDP.

Throughout recent years, monetary policy has been conducted in alignment with the primary objective of sustained price stability. Consistently, since December 2015, the policy rate has been raised three times, for a total of 125 basis points. These moves were preemptive, as inflation has remained under control. The hikes sought to fortify macroeconomic fundamentals in conjunction with announced government expenditure cuts, and to avert deviation of inflation expectations from the target that may arise from pass-through.

Going forward, the implications of exchange-rate developments will remain an important input in monetary policy decisions. But let us be clear: the Bank of Mexico does not target any exchange-rate level and hence, there does not exist a benchmark value at which monetary policy would react. This does not mean, however, that the effects of currency

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8 Analysts' average estimates for Mexico's GDP growth are 2.2 percent in 2016 and 2.5 percent in 2017. See Blue Chip Economic Indicators 2016, September. From 1994 to the 2016 first half, annual GDP growth averaged 2.6 percent.

9 See Banco de México (2016). "Encuesta sobre las Expectativas de los Especialistas en Economía del Sector Privado: Agosto de 2016," September.

behavior are irrelevant. They will continue to be taken into account to the extent that they may impact inflation and expectations.

Other factors considered by monetary policy include the state of the economy and the relative monetary stance vis-à-vis that of the United States, especially important given the close nature of the U.S.-Mexican relationship.

In short, monetary policy must remain on guard. Its lags are long and variable. It will continue to be implemented with all the flexibility, timeliness, and independence required to consolidate price stability.

Concluding remarks

As with the United States as a whole, Texas and Mexico continue to enjoy longstanding and profound cultural, social, and economic ties. Mutual benefits accrue on both sides of the border from bilateral trade, as well as capital and labor investments. Ongoing structural reforms in Mexico should enhance this process.

Significant not only for Mexico, but for the larger emerging-market universe, is the influence of U.S. monetary policy. Shifting expectations for U.S. policy moves have tended to fuel volatility in global financial assets, with prices tending to move in the opposite direction of economic news. Mexican markets have adjusted to changes in views on U.S. monetary policy normalization mainly through the exchange rate. The Mexican peso has depreciated more than other emerging-market currencies this year, with idiosyncratic factors partly responsible for this trend.

Mexico’s economic dynamism faces downside risks, particularly those coming from slowing U.S. manufacturing production. Also, given a context of greater risk aversion, which could become worse, Mexico needs to reinforce its fiscal stance. Monetary policy, for its part, will continue to be implemented with flexibility and timeliness, keeping at bay dangers to sustained convergence of inflation to the permanent target.